

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Cogdill Analyst: Kimberly Pantoja Bill Number: AB 1054

Related Bills: See Legislative History Telephone: 845-4786 Amended Date: 04/03/01

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Irrigation System Improvement Costs Credit

SUMMARY

This bill would create a tax credit for 50% of the cost of a farm irrigation system improvement that results in water conservation or savings.

SUMMARY OF AMENDMENTS

The April 3, 2001, amendments replaced the bill language regarding property taxation as introduced February 23, 2001, with the proposed credit for irrigation system improvement costs.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's staff, this bill is intended to reward agri-businesses for being good stewards of the land entrusted to them by utilizing the tax system to provide a credit for installing an irrigation system improvement.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The bill would be operative for taxable years beginning on or after January 1, 2001, and does not have a sunset date.

POSITION

Pending.

Summary of Suggested Amendments

An amendment is provided to address the department's technical concern. Department staff is available to assist with amendments to resolve the implementation and policy concerns described below.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for GHG

05/10/01

ANALYSIS

FEDERAL/STATE LAWS

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade or business or as investment property. The property must have a useful life of more than one year and includes equipment, machinery, vehicles, and buildings, but excludes land. The property is then depreciated over its useful life (recovery period).

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business. Expenses related to water conservation qualify to the extent that they are ordinary and necessary business expenses and are not for the purchase of property with a useful life of more than one year.

Existing state and federal laws allow taxpayers to use various credits against tax. Neither state nor federal laws have a tax credit similar to the one proposed by this bill.

THIS BILL

This bill would allow all taxpayers that own or lease land to claim a tax credit equal to 50% of the costs of purchasing and installing an irrigation system improvement. The system must be used in a business for the production of farm income and result in water conservation or savings.

This provision would extensively define the term "irrigation system improvement" in terms of the types of qualifying equipment and the impact on water use. An irrigation system improvement also would be defined to include a physical improvement, an alteration of real property, or an installation of equipment certified to meet the bill's criteria. Certification can be given by a registered civil engineer, registered agricultural engineer, or certified irrigation designer who is independent of the taxpayer and the seller or provider of the physical improvement, alteration, or equipment.

The basis of the irrigation system improvement would be reduced by the amount of the allowable credit.

Any excess credit could be carried over indefinitely. However, any unused carryover credit would be disallowed if the taxpayer sells the land on which the irrigation system improvement was installed.

IMPLEMENTATION CONSIDERATIONS

The credit permits, but does not require, an engineer or designer to provide certification of an irrigation system improvement. It would be helpful for audit purposes if an engineer or designer were required to certify every irrigation system improvement that is eligible for the credit because the department lacks the expertise in farming or water management necessary to determine if a system meets the required criteria.

The requirement that the certifying engineer or designer be “independent of” the taxpayer is a subjective, undefined standard and may be open to interpretation. Providing an objective relationship standard would make it clear that the engineer or designer may not be an employee or otherwise related to the purchaser, seller, or manufacturer of the irrigation system improvement. The author may wish to use “related party” and provide a definition for that term to resolve this issue.

TECHNICAL CONSIDERATION

Amendment 1 is provided to correct a reference from "income" year to "taxable" year.

LEGISLATIVE HISTORY

SB 435 (Monteith, 2001/2002) contains similar credit language as this bill and is currently in the Senate Revenue and Taxation Committee.

SB 1974 (Poochigian, 1999/2000) contained similar credit language as this bill, but did not pass the Senate Revenue and Taxation Committee.

SB 229 (McPherson, 1999/2000), AB 1081 (House, 1997/1998), and SB 1402 (McPherson, 1997/1998) would have allowed a tax credit similar to the one proposed by this bill. SB 229 and AB 1081 failed to pass the first house by January 31 of the second year, while SB 1402 failed passage in Senate Revenue and Taxation Committee.

PROGRAM BACKGROUND

A similar tax credit for the purchase and installation of water irrigation systems expired on December 31, 1985. That credit, taken in the year of installation, was equal to the lesser of 10% of the cost or a maximum of \$500 and was provided in addition to any other qualified deductions.

OTHER STATES' INFORMATION

Review of *Florida, Illinois, Michigan, Texas, and New York* laws found no comparable tax credits or deductions. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

Once the implementation concerns are resolved, this bill is not expected to impact the department's costs significantly.

ECONOMIC IMPACT

Tax Revenue Estimate

This bill would result in revenue losses as follows:

Revenue Impact of AB 1054 As Amended April 3, 2001 \$ Millions			
	2001-02	2002-03	2003-04
Irrigation System Improvements	-\$21	-\$30	-\$35

Any changes in employment, personal income, or gross state product that could result from this measure are not considered.

Revenue Estimate Discussion

The estimate was developed in several steps. Discussions with industry experts indicated that replacing existing systems as well as the incentive effect of this bill would induce about 200,000 acres of irrigated land in California to adopt water-saving systems or equipment. Discussions with industry experts indicated the average cost per acre to install the equipment and improve the irrigation system was calculated at about \$525 per acre for 2000. Total qualifying expenditures are projected to be on the order of \$100 million for 2001. The applied credit amounts were adjusted to account for the reduction in depreciation that would result from the use of the credits. The portion of credits that could be applied in any given year against available tax liabilities was estimated using tax returns that report farm income. It was assumed that unapplied carryover credits would be exhausted by the fourth year.

ARGUMENTS/POLICY CONCERNS

Because this provision requires an adjustment to basis, it would create a state and federal difference, thus increasing the complexity of tax return preparation. However, disallowing the adjustment would mean that the taxpayer would receive a double tax benefit with respect to the same expenses.

The credit recapture provision would create disparate treatment among taxpayers depending upon their status as a landowner or a lessee of farmland. For example, this provision would recapture the credit carryover for a landowner who purchases an irrigation system improvement and subsequently sells the land on which the improvement was installed. Conversely, a credit carryover would be allowed to a taxpayer that leases the same land and terminates the lease after incurring the costs qualifying for this credit, even if the system were removed from the leased property.

Further, the timing of use of the credit to offset tax liability also could create disparate treatment among taxpayers. A landowner that is able to fully utilize the credit against tax liability in the year of installation would suffer no recapture penalty if the property were sold the following year. This is in contrast with a landowner that was unable to use the credit prior to a sale.

Since recapture is limited to the sale of land on which the irrigation system was installed and not the sale of the irrigation system improvement itself, the recapture provision also creates disparate treatment for different types of irrigation system improvements. There would be recapture when land is sold with systems installed, but not if the irrigation system improvement were sold independent of any sale of the land on which it is installed.

The bill would allow the credit to multiple taxpayers for the same property or irrigation system improvement if the property or system were sold. The author may wish to amend the bill to allow the credit only for the taxable year in which the system is first placed in service to resolve this concern.

The credit does not specify a repeal date or any limitation on the carryover period. Credits typically are enacted with a repeal date to allow the Legislature to review the effectiveness of the credit. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1054
As Amended April 3, 2001

AMENDMENT 1

On page 4, line 3, strike "income" and insert:

taxable